Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-5831-97
AJKim

date:

to: Chief, Examination Division, Manhattan District
Attn: Philip Bogitsh

from: District Counsel, Manhattan

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subject: [redacted]
Proper Entity Classification of [redacted]

Uniform Issue List #7701.02-00

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or to their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memorandum is in response to your request for advice concerning the proper entity classification for federal tax purposes of [redacted], a foreign entity in which the above-referenced taxpayer held a majority interest, for the tax years [redacted], [redacted] and [redacted]. It is based, in part, on informal consultations with attorneys Daniel Carmedy and Lori C. Gardner in the National Office of Chief Counsel.

Ms. Gardner has agreed that use of 10 day post-review is proper with respect to this advice. Thus, no actions based on this advice should be taken until we have informed you that the National Office has confirmed the accuracy of the advice.

ISSUE

Whether [redacted], a [redacted] entity, was properly classified as a partnership rather than as a corporation for U.S. federal tax purposes for the tax years [redacted], [redacted] and [redacted]?

CONCLUSION

[redacted]'s classification as a partnership for tax years [redacted], [redacted] and [redacted] falls within the grandfather exception contained within the new entity classification regulations effective on January 1, 1997 and, therefore, must be respected.

Moreover, even if its prior classification does not apply under the new, entity classification regulations, [redacted] did not possess more corporate characteristics than non-corporate characteristics in the tax years at issue to warrant classification as a corporation for U.S. federal tax purposes under the old regulations.

FACTS

On [redacted], [redacted], a [redacted] corporation, merged with and into [redacted], a [redacted] corporation formed previously on [redacted]. Prior to the merger, [redacted] engaged in [redacted] in [redacted]. [redacted], a [redacted] corporation, held all [redacted] ([redacted]) [redacted] outstanding shares of [redacted]. [redacted], a [redacted] partnership, held all [redacted] outstanding shares of [redacted]. [redacted] filed its returns on a fiscal year basis with its tax year ending on the last Friday of November of each year. [redacted] filed its [redacted] Form 1065 (U.S. Partnership Return of Income) on [redacted].

Following the merger, [redacted] continued the historic business of [redacted] in [redacted]. Beginning in [redacted], [redacted] operated with a fiscal year ending on March 31st based on the requirements of [redacted] law. [redacted], formed in the [redacted] by [redacted], held all outstanding shares of [redacted]. Through a series of transactions, [redacted] acquired approximately [redacted]

[redacted] shares of [redacted]'s common stock.[1] Thereafter, on [redacted], [redacted] received an additional [redacted] shares of [redacted]'s common stock in exchange for $[redacted] in cash. Thus, [redacted] held all outstanding common stock of [redacted], totaling [redacted] shares.

In a private letter ruling, the Internal Revenue Service ("IRS" or "Service") determined that the merger of [redacted] with and into [redacted] constituted a reorganization within the meaning of section 368(a)(1)(F)[2] and temporary regulations section 7.367(b)-7(b). Priv. Ltr. Rul. [redacted]. The Service determined that [redacted] and [redacted] were each a "party to a reorganization" within the meaning of I.R.C. § 368(b). Accordingly, the Service concluded, in part, that no gain or loss would be recognized to (and no amount will be included in the income of) [redacted] upon receipt of the [redacted] stock pursuant to section 355(a)(1).

On [redacted], [redacted] was organized in the [redacted] under the International Business Companies Ordinance, 1984 ("Companies Ordinance"). On the same date, [redacted] filed its Memorandum of Association and Articles of Association.

By members' resolution filed with the [redacted] Registrar's Office on [redacted], [redacted] added new language to its Articles of Association regarding the termination of [redacted] as follows:

> TERMINATION The Company shall terminate, commence to wind-up and dissolve upon the death, insanity, bankruptcy, retirement, resignation or expulsion or any member unless within 45 days of such event all remaining members agree, in accordance with the procedures contained in the Articles of Association, to continue the existence of the Company.

Further, the member's resolution provided that no member could transfer, sell, assign, mortgage, charge, pledge or otherwise dispose of or encumber shares in the Company [redacted], in whole or in part, unless a majority (in number) of the members, and members who hold in aggregate a majority of the outstanding shares of the Company agreed by resolution to permit such action.

On [redacted], [redacted] adopted its amended Memorandum of

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[1]See Priv. Ltr. Rul. [redacted] for details regarding these transactions.

[2]All section references are to the Internal Revenue Code in effect during the years at issue.

Association and Articles of Association and, as a consequence, considered a deemed liquidation to have occurred. However, [redacted] did not file dissolution papers with the government to terminate the corporation.

In a statement attached to Form 5471 (Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of Its Stock) filed as part of its Form 1065 (U.S. Partnership Return of Income) for its fiscal year ending [redacted], [redacted] represented that on [redacted], [redacted] distributed all of its assets and liabilities to [redacted], its [redacted] percent shareholder, in complete liquidation of [redacted]. [redacted] noted on Form 5471 that it constituted the "FINAL RETURN" for "[redacted]." Additionally, on Form 5471, [redacted] listed [redacted]'s principal business activity as "[redacted]."

[redacted] treated the distribution received by [redacted] as being in full payment in exchange for the stock of [redacted] under section 331(a). [redacted] reported the total gain realized by [redacted] upon the liquidation of [redacted] in the amount of $[redacted]. See I.R.S. Notice 95-14, 1995-1 C.B. 297.

In its Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership), [redacted] declared [redacted] as a partnership organized under the laws of the [redacted] on [redacted]. In a statement attached to Form 926, [redacted] listed four (4) partners of the new, [redacted] "foreign partnership": (1) [redacted]; (2) [redacted]; (3) [redacted]; and (4) [redacted]. In [redacted], the individuals [redacted], [redacted] and [redacted] were also partners in [redacted]. In its Form 1065 filed for [redacted], [redacted] reported non-passive, foreign income from [redacted], a foreign partnership of which [redacted] declared itself to be a [redacted]% partner.

In its Form 1065 filed for [redacted], [redacted] reported income from [redacted], which it listed as a "foreign partnership", in the amount of $[redacted]. Of $[redacted] foreign tax credits which [redacted] reported from the activities of [redacted], [redacted] percent was allocated between [redacted], [redacted] and [redacted] with the remaining [redacted] percent allocated to [redacted].

In [redacted], the Examination Division initiated an audit of [redacted] with respect to its fiscal years [redacted], [redacted] and [redacted]. The Examination Division did not notify [redacted] or any of its individual partners in writing on or before [redacted] that the classification of [redacted] as a partnership for U.S. federal tax purposes was under examination for the years [redacted], [redacted] and [redacted].

DISCUSSION

New entity classification (commonly known as "check-the-box") regulations became effective as of January 1, 1997. Treas. Reg. § 301.7701-1(b), (f). These new regulations replaced the formalistic classification rules with simpler, elective rules. Under the old regulations, an entity possessing at least three of the following four characteristics was treated as a corporation: free transferability of interests, unlimited life, centralization of management and limited liability.

In order to uniformly classify entities organized under foreign law for federal tax purposes prior to "check-the-box", the classification of foreign unincorporated business organizations was determined under section 7701 and the regulations thereunder. Rev. Rul. 73-254, 1973-1 C.B. 613. All foreign entities were considered to be unincorporated organizations for purposes of section 301.770-1-2(a)(3) of the prior regulations. Rev. Rul. 88-8, 1988-1 C.B. 403, obsoleted by Rev. Rul. 98-37, 1998-32 I.R.B. 5. Thus, no foreign organization or entity could be classified as an association unless such organization or entity possessed more corporate than non-corporate characteristics. Id. Although [redacted] is a corporation organized under the laws of the [redacted], it cannot be classified for federal tax purposes on the basis of the label attached to it by the statute under which it is established. Rev. Rul. 88-8, obsoleted by Rev. Rul. 98-37.

Though effective as of January 1, 1997, the "check-the-box" regulations provide a grandfather exception for an entity's claimed classification prior to the effective date if the entity meets the conditions set forth under Treasury regulation section 301.7701-3(f)(2). Because [redacted]'s classification as a partnership beginning in fiscal year [redacted] satisfies Treasury regulation section 301.7701-3(f)(2), its classification must be respected.

The preamble of the final "check-the-box" regulations provides, in part, that:

> The IRS will not challenge the prior classification of an existing eligible entity, or an existing entity described on the per se list, for periods prior to January 1, 1997, if [the eligible entity meets the elements listed in section 301.7701-3(f)(2)]." T.D. 8697, 1997-2 I.R.B. (emphasis added).

Treasury regulation section 301.7701-3(f) provides:

> **(1) In general.** The rules of this section are effective as of January 1, 1997.
>
> **(2) Prior treatment of existing entities.** In the case of a business entity that is not described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if-
>
> > (i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;
> >
> > (ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and
> >
> > (iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

With at least two members, [redacted] is an "eligible entity" which can elect to be classified as either an association or a partnership under the new regulations. Treas. Reg. § 301.7701-3(a). [redacted] is not a trust as defined under section 301.7701-4 or an entity described in sections 301.7701-2(b)(1), (3), (4), (5), (6) and (7). Treas. Reg. § 301.7701-2(a). Treasury regulation section 301.7701-1(d) defines an entity as "foreign" if it is not created or organized in the United States or under the laws of the United States or of any State. As an entity created and organized under the laws of the [redacted], [redacted] is a foreign entity. Treas. Reg. § 301.7701-1(d). Further, with two or more members and one member who does not have limited liability, [redacted] qualifies as a "foreign eligible entity". Treas. Reg. §301.7701-3(b)(2)(i)(A). See discussion regarding limited liability, below.

Treasury regulation sections 301.7701-3(b)(3)(i) and (ii) define a foreign entity as being "in existence" prior to January 1, 1997 "...only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section." Section 301.7701-3(d) provides, in part, that a foreign eligible entity's

classification is "relevant" when its classification affects the liability of any person for federal tax or information purposes. On [redacted], in Form 5471 filed along with its Form 1065 for its fiscal year [redacted], [redacted] reported a total gain realized in the amount of $[redacted] upon the liquidation of [redacted]. Because [redacted]'s classification affected the liability of [redacted] within the 60 months prior to January 1, 1997, it was "in existence" prior to January 1, 1997. Treas. Reg. §§ 301.7701-3(b)(3)(i), 3(d)(1); see also I.R.S. Notice 95-14, 1995-1 C.B. 297.

Treasury regulation section 301.7701-3(f)(2)(i) directs an inquiry into whether the entity had a reasonable basis for its claimed classification. Reasonable basis is a higher standard than "not patently improper" and is not satisfied by a return position that is merely an arguable or colorable claim. See H. Rep't No. 103-213, 103d Cong., 1st Sess. 669 (1993) (the Conference Report for RRA '93); see also Treas. Reg. § 1.6662-3(b)(3)(ii) ("The reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in § 1.6694-2(c)(2).").

Reasonableness of the claimed classification prior to January 1, 1997 must be determined under entity classification regulations effective prior to "check-the-box." Cf. Treas. Reg. § 301.7701-3(b)(3)(ii) (for purposes of applying Treasury regulation § 301.7701-3, determination of the entity's classification prior to January 1, 1997 is determined under pre-"check-the-box" regulations where no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity). Thus, if it is determined that [redacted] possessed less than three of the corporate characteristics prior to January 1, 1997 there would exist reasonable basis for its claimed classification since it would have been classified as a partnership under the old regulations.

The prior Treasury regulations considered a number of characteristics common to a corporation in determining whether an entity was a corporation such as: (i) Associates, (ii) an objective to carry on a business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property (limited liability), and (vi) free transferability of interests. Former Treas. Reg. § 301.7701-2(a)(1). Whether a particular organization was to be classified as an association, and therefore, taxed as a corporation rather than as a partnership or trust, was determined by taking into account the presence or absence of each of these corporate characteristics. Former Treas. Reg. § 301.7701-2.

Under the prior Treasury regulations, an organization was treated as an association if the corporate characteristics were such that the organization more nearly resembled a corporation than a partnership or a trust. Former Treas. Reg. § 301.7701-2(a)(1); see Morrissey v. Commissioner, 296 U.S. 344, 357 (1935). More specifically, an unincorporated organization would only be classified as an association if such organization had more of the corporate characteristics listed above than non-corporate characteristics. Former Treas. Reg. § 301.7701-2(a)(3); see also Larson v. Commissioner, 66 T.C. 159, 172 (1976), acq., 1979-1 C.B. 1 (each characteristic bears equal weight); Zuckman v. U.S., 524 F.2d 729, 734 (Cl. Ct. 1975); Rev. Rul. 88-8, obsoleted by 98-37.

The prior Treasury regulations further provided that the factors of associates and business purpose are common to both corporations and partnerships; accordingly, these characteristics were not considered in making the classification analysis. Former Treas. Reg. § 301.7701-2(a)(2). Thus, the determination of whether a partnership was taxable as an association under pre-"check-the-box" regulations rests primarily on the existence of more than two of the remaining factors: Continuity of life, centralization of management, limited liability, and free transferability of interests. Rev. Rul. 79-106, 1979 C.B. 448; see also Zuckman, 524 F.2d at 733.

Limited Liability

Prior Treasury regulation section 301.7701-2(d)(1) provided that an organization will have the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts or claims against the organization. Personal liability means that a creditor may seek satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claims. Former Treas. Reg. § 301.7701-2(d)(1).

The [redacted] Articles of Association defines a member as a person who holds shares in [redacted]. Similarly, the Companies Ordinance defines a "member" as a person who holds shares in a company. Companies Ordinance, Part I, Section 2. For the tax years [redacted], [redacted] and [redacted], [redacted] had four shareholders/members: (1) [redacted]; (2) [redacted]; (3) [redacted]; and (4) [redacted].

[redacted] of Companies Ordinance provides, in part, that:

> ... no member, director, officer, agent or liquidator of a company incorporated under this Ordinance is liable for any debt, obligation or default of the company, unless specifically provided in this Ordinance or in any other law for the time being in force in the [redacted].

Accordingly, [redacted] possessed the corporate characteristic of limited liability during the years at issue.

Continuity of life

Prior Treasury regulation section 301.7701-2(b)(1) provided that an organization will lack continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause the dissolution of the organization. In determining whether any member has the power of dissolution, it is necessary to examine the Articles of Association and to ascertain the effect of such agreement under local law, if necessary. Former Treas. Reg. § 301.7701-2(b)(3).

Under its amended Articles of Association, [redacted] would terminate, commence to wind-up and dissolve upon the death, insanity, bankruptcy, retirement, resignation or expulsion or any member unless within 45 days of such event all remaining members agreed, in accordance with the procedures contained in the Articles of Association, to continue its existence. This provision to continue by agreement of all remaining members, upon such an event as the death of any member, did not affect the vested power of the remaining members to dissolve the organization under local law. The Companies Ordinance provided, in part, that:

> ....a company...shall commence to wind up and dissolve by resolution of directors....or upon the happening of an event which has been specified in the Memorandum or Articles as an event that shall terminate the existence of the company.").

[redacted] Companies Ordinance. Accordingly, [redacted] did not possess the corporate characteristic of continuity of life. Former Treas. Reg. § 301.7701-2(b)(3).

Free Transferability of Interests

The prior Treasury regulations provided that an organization possesses the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves a person who is not a member in the organization. Former Treas. Reg. § 301.7701-2(e)(1). The member must be able to confer upon his substitute all of the attributes of his interest in the organization. Id.

Under the amended Articles of Association, no member of [redacted] could transfer, sell, assign, mortgage, charge, pledge or otherwise dispose of or encumber shares in [redacted], in whole or in part, unless a majority (in number) of the members, and members who held in aggregate a majority of the outstanding shares of [redacted] agreed by resolution to permit such action. Because each member could not transfer shares of [redacted] without the consent of other members, the corporate characteristic of free transferability of interest does not exist. Id.

Centralization of Management

Prior Treasury regulation 301.7701-2(c)(1) provided that an organization will possess the corporate characteristic of centralization of management where the effective operation of the organization generally depends upon the hands of a few of exclusive authority. Section [redacted] of [redacted]'s Articles of Association state that the Board of Directors shall have general power to administer and direct the affairs of [redacted]. Further, paragraph [redacted] of the Memorandum of Association provides that any failure of the members to approve or ratify contracts or transactions executed by the Board shall not render them invalid or deprive the directors and officers of their right to proceed with such contract or other transaction. The [redacted] Board of Directors possessed the authority to make management decisions without ratification by the organization's members. Accordingly, the corporate characteristic of centralization of management exists. Former Treas. Reg. §§ 301.7701-2(c)(3), (4).

While [redacted] possesses the corporate characteristics of limited liability and centralization of management, it lacks the remaining characteristics of continuity of life and free transferability of interests. Because [redacted] did not possess more of the corporate characteristics than non-corporate characteristics for the years at issue, there was a reasonable basis for its claimed classification as a partnership in tax years [redacted], [redacted] and [redacted]. Treas. Reg. § 301.7701-3(f)(2)(i).

Additionally, on Form 5471 listing the "FINAL RETURN" of [redacted] as a corporation for federal tax purposes, [redacted] reported a total gain realized in the amount of $[redacted] upon its deemed liquidation of [redacted]. Since [redacted] and its members recognized the federal tax consequences of the change in [redacted]'s classification on [redacted], when it filed its [redacted] federal tax forms and a date within 60 months prior to January 1, 1997, the requirement of Treasury regulation section 301.7701-3(f)(2)(ii) is satisfied. See I.R.S. Notice 95-14, 1995-1 C.B. 297 ("...if an organization were classified as an association taxable as a corporation and later elected to be classified as a partnership, the election would be treated as a complete liquidation of the corporation and a formation of a new partnership. Thus, a final return for the corporation and a first-year return for the partnership each would have to be filed."). Finally, we have confirmed with the Examination Division that neither [redacted] nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination. Treas. Reg. § 301.7701-3(f)(2)(iii).

Having satisfied all the elements set forth under section 301.7701-3(f)(2), [redacted]'s claimed classification prior to January 1, 1997 must be respected. We note that even if [redacted]'s claimed classification does not meet the requirements of section 301.7701-3(f)(2) of the new regulations, it nonetheless fails to possess more corporate than non-corporate characteristics to be classified as a corporation under the prior regulations.

Should you have any questions regarding this matter, please contact Anthony J. Kim of this office at (212) 264-5473 - extension 251.

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